The inherent limits of 'legal devices': lessons for the public sector's central counterparty prescription for the OTC derivatives markets

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The Inherent Limits of 'Legal Devices': Lessons for the Public Sector's Central Counterparty Prescription for the OTC Derivatives Markets

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Abstract

In the wake of the financial crisis considerable momentum has built up behind proposals to extend central counterparty (CCP) clearing in the over-the-counter derivatives markets. However, implementation is proving complex. This paper argues that one cause of this complexity is that the public sector is seeking to incorporate into legislation (and require the wider use of) a privately owned and operated risk management mechanism. As a matter of law, the paper argues that

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CCP clearing can be understood as a market-generated 'legal device'; in other words, one designed to support the markets by means of the interaction of various private law techniques. Following this analysis through, the paper highlights the benefits and drawbacks which derive from the legal techniques underlying CCP clearing (standardisation of contracts, asset-backing, netting and so on) and argues that these qualities are inherent to the device. It concludes that the inherent capacity of CCP clearing gives rise to a qualitatively different set of challenges for policy-makers to those arising from technical implementation and it explains that both types of problem need to be addressed if the CCP prescription is to be effective.

Keywords: OTC derivatives, credit default swaps, central counterparty clearing, CCPs, clearing houses, netting, collateral, contract, Dodd-Frank Act, regulatory reform.

1. INTRODUCTION

Traditionally regarded as an important but unglamorous part of the infrastructure of the financial markets, commentators have often subjected central counterparty (CCP) clearing to metaphors about plumbing.[1] CCP clearing services are operated by clearing houses such as LCH.Clearnet Ltd or ICE Clear Europe, which are private entities authorised and supervised in the UK by the Financial Services Authority (FSA).[2] The job of CCPs is to provide clearing services to members and exchanges, reducing risk and increasing efficiencies in the post-trade and pre-settlement period. How they achieve these important effects as a matter of law is one of the questions which is central to this paper.

As states and other regulators have considered their responses to the financial crisis, CCPs have come to assume a prominent place in the debate. Specifically, the recommendation that CCP clearing should be required for over-the-counter (OTC) derivatives as a way of increasing transparency and stability in those markets has been endorsed by the G20, the European Commission, the European Central Bank,

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[1] For example, 'Counter Insurgency; The Craze for Clearing Houses', *The Economist*, 27 June 2009 (where CCPs are described as 'part of the financial plumbing'); 'Making a Stink; Credit Derivatives', *The Economist*, 1 July 2006; N. Aubry, 'Regulating the Plumbing of Europe', 23 *Journal of International Banking Law and Regulation* (2008) p. 578; and P. Wood, 'What Is a Central Counterparty in the Financial Markets?', *Allen & Overy*, 20 August 2009, noting the usual metaphors and expressing a preference for a comparison with cathedral columns, available at: <http://www.allenovery.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=52783&prefLangID=410>. (All websites last visited 14 October 2010).

[2] The regulatory framework is discussed in B. Penn, 'Recognised Investment Exchanges (RIEs) and Recognised Clearing Houses (RCHs)', in M. Blair and G. Walker, eds., *Financial Markets and Exchanges Law* (Oxford, OUP 2007).

the Obama administration, and HM Treasury and the FSA amongst others.[3] On the basis of the shared features of these authorities' recommendations, I label this reform the 'CCP prescription' for the OTC derivatives markets. However, as I discuss below, this is not to downplay the important differences in detail between what various parties are proposing.

While these different national and transnational legislative processes run their course, influential market actors have also endorsed the CCP prescription. As early as August 2008, the US-based industry group which was set up to provide a 'private sector' response to the crisis, the Counterparty Risk Management Policy Group III, published a report which amongst other recommendations 'urge[d] swift industry action to create a clearinghouse for OTC derivatives, starting with CDS'.[4] In October 2008, major US dealers and three leading trade associations wrote the President of the Federal Reserve Bank of New York, committing to seven goals to 'make OTC derivative processing more scalable, transparent and resilient' including the 'global use of central counterparty processing and clearing to significantly reduce counterparty credit risk and outstanding net notional positions'.[5] In a February 2009 letter to European Commissioner Charlie McCreevy, nine of the leading dealer firms in the market committed to using EU-based central clearing for 'eligible EU CDS contracts', as announced by the leading trade association, the International Swaps and Derivatives Association (ISDA).[6] By August 2009, seven clearing houses for CDS had launched or were due to launch shortly in the US (ICE US Trust, CME), the UK (NYSE LIFFE/BClear and LCH.Clearnet, and ICE Clear Europe), Germany (Eurex) and France (LCH.Clearnet S.A.).[7]

However, concluding from all this momentum that the CCP prescription is one of the more uncontroversial or straightforward elements of the public sector's

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[3] The detail of the international consensus behind this reform and its progress into legislation is discussed in section 2 of the paper below.

[4] Counterparty Risk Management Policy Group III, *Containing Systemic Risk: The Road to Reform. The Report of the CRMPG III* (6 August 2008), at p. 1. 'CDS' are credit default swaps which are one type of OTC derivative. They have attracted particular attention during the debate about the CCP prescription and are discussed in more detail in section 2.1 of the paper below.

[5] Letter from senior managements of sixteen major dealers, the International Swaps and Derivatives Association (ISDA), the Managed Funds Association and the Asset Management Group of the Securities Industry and Financial Markets Association to Timothy F. Geithner, President, Federal Reserve Bank of New York, 31 October 2008 (making reference to correspondence between the parties earlier in 2008), available at: <http://www.isda.org>.

[6] ISDA, 'Major Firms Commit to EU Central Counterparty for CDS', News Release, 19 February 2009. ISDA's role in reforming the derivatives industry, including in the context of clearing initiatives, is discussed in more detail in R. Pickel, 'Navigating the Financial Crisis: Choosing the Right Path for the Derivatives Industry', 4(S1) *Capital Markets Law Journal* (2009) p. S69.

[7] European Central Bank/Eurosystem, *Credit Default Swaps and Counterparty Risk*, August 2009, at p. 77, available at: <http://www.ecb.int/pub/pdf/other/creditdefaultswapsandcounterpartyrisk2009en.pdf>.

legislative response to the financial crisis would be a mistake. In fact, as the public debates surrounding the issue reveal, settling the detail of new legislation to mandate further CCP clearing of OTC derivatives has turned out to be an extremely difficult task, involving technical decisions on a host of matters. The public debates thus far have addressed a range of such matters simultaneously, including what types of derivatives the reform should cover, what qualities are needed for a derivatives contract to be 'clearing eligible', whether clearing should be mandatory or recommended, how non-cleared (or non-clearable) contracts should be regulated, where CCPs should be located, how many there should be, who should bail them out and so on. Each of these details goes to the heart of how the CCP prescription will work and, if not confronted effectively, threatens to frustrate any new rules which policymakers produce about clearing in the OTC derivatives market.

Against this background, there are several ways in which academics might seek to contribute to the debate, including by considering why the CCP prescription has come to overshadow other regulatory approaches. However, this paper focuses on the nature and capacity of CCP clearing itself and the consequences for the debate about the public sector's implementation of the CCP prescription. The emphasis in this paper is on the role of private law, which has featured less prominently in the debates than some other perspectives,[8] but which offers valuable insights into the process of implementing this reform.[9] The thesis which I advance in this paper is that:

(1) implementing the CCP prescription is proving complex in part because the public sector is seeking to incorporate into legislation (and require the wider use of) a privately owned and operated risk management mechanism. However, the implications of incorporating mandatory CCP clearing into financial regulatory reform have not been addressed in a systematic way in the public debates, which have tended to ask 'how will this reform work?' rather than first dealing with the question of 'how does CCP clearing work?'.

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[8] For example, academics from the disciplines of finance and economics were well-represented at the high-level conference organised by the European Commission on 25 September 2009 to conclude its public consultation on OTC derivatives markets. The agenda and materials from this conference are available at: <http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm>. There has also been some input to the CCP debate from practising lawyers. For example, a detailed discussion by an experienced securities lawyer, covering the history of regulatory interest in OTC derivatives, changes to documentation and market practice and addressing the limits on the kinds of OTC credit derivatives that can be cleared is set out in A. Glass, 'The Regulatory Drive towards Central Counterparty Clearing of OTC Credit Derivatives and the Necessary Limits on This', 4(S1) *Capital Markets Law Journal* (2009) p. S79.

[9] Indeed, as I suggest in section 3 of the paper, a private law analysis is a valuable way in which to consider the function and capacity of a range of complex, market-generated legal devices. This mode of analysis therefore has the potential to contribute to the debates about regulatory reform in a number of areas beyond the OTC derivatives market.

(2) CCP clearing can be analysed in different ways depending on the disciplinary perspective being used, but as a matter of law it can be understood as a market-generated 'legal device'; in other words, it is designed to serve the markets by means of the interaction of various private law techniques. Following this analysis through highlights the benefits but also the drawbacks which derive from the underlying legal techniques (standardisation of contracts, asset-backing, netting and so on).
(3) These strengths and weaknesses are inherent to the device. This means that they have to be recognised and managed upfront by policymakers intending to incorporate CCP clearing of OTC derivatives into their regulatory response to the financial crisis.
(4) The inherent capacity of CCP clearing represents a qualitatively different set of challenges for policymakers to those arising from the implementation of the CCP prescription; however, both types of problem need to be addressed if the CCP prescription is to be effective.

The rest of this paper is organised into three main parts. The first provides the background to the CCP prescription, charting the problems which have been diagnosed in parts of the OTC derivatives markets in the wake of the financial crisis, the emergence of the official consensus behind an extension of CCP clearing and the ongoing attempts to settle the detail of this reform.

The following part considers the function and capacity of CCP clearing. Contextualising CCP clearing alongside other 'legal devices' which facilitate market activity, I argue that the benefits and weaknesses of such devices are usefully highlighted by taking a private law perspective. I go on to consider, as a matter of English law, the legal techniques underlying CCP clearing as a way of understanding the capacity of this particular legal device.

The next part of the paper returns to the ongoing policy debates about the CCP prescription. On the basis of the preceding analysis, I suggest that it is helpful to isolate two different types of challenges confronting policymakers. The paper concludes with thoughts about how the debates about the CCP prescription may usefully proceed.

2. THE CCP PRESCRIPTION FOR THE OTC DERIVATIVES MARKETS

The financial crisis which began in 2007 with, as Lord Turner has put it, 'an initial crack in confidence and collapse of liquidity'[10] brought the international banking

[10] A. Turner, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (London, FSA, March 2009), at p. 27. George Soros has also written that 'the outbreak of the current financial crisis can be officially fixed at August 2007': G. Soros, *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Means* (New York, PublicAffairs 2008), at p. xiii.

system to the brink of collapse and continues to have devastating effects on the real economy. Since then, a significant part of the debate about 'what went wrong'[11] and what should happen now has focused on the OTC derivatives markets.

2.1 OTC derivatives and the financial crisis

OTC derivatives are often defined as those derivatives which are entered into privately rather than on an organised exchange. This is a useful definition, though in practice the distinction is not always this clear cut.[12] The most important types of OTC derivatives are interest rate, credit, foreign exchange, equity and commodities derivatives. As discussed below, new and proposed legislation mandating CCP clearing seeks to catch all types of OTC derivatives (exceptions in the legislation published so far turn on the nature of the party entering the contract, not the type of derivative in question). However, the momentum for this reform originated in the immediate aftermath of the crisis, when the debate focused on credit default swaps (CDS), a type of credit derivative.

Legally speaking, a CDS is a bilateral contract where the rights and obligations of the parties derive not from the price of a commodity or a currency (as in other sorts of derivatives) but from the credit risk of a reference entity or asset.[13] Under a CDS contract, a 'protection buyer'[14] contracts with a counterparty and in return for a premium buys protection against particular credit events (which should be carefully defined in the contract).[15] CDS emerged as a class of OTC product in the mid-1990s, and since then, the growth of the market has been staggering.[16] However, by the outbreak of the crisis in 2007, various factors had made this market particularly fragile. The Turner Review, for instance, drew attention to the 'sheer size and complexity of the market and the fact that it is traded in an almost entirely Over-the-counter (OTC) fashion'.[17]

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11 The title of the Turner Review, ibid., chapter 1.

12 As demonstrated in E. Murray, 'UK Financial Derivatives Commodities Markets', in Blair and Walker, eds., *supra* n. 2, at pp. 273-4.

13 See the definition of derivatives generally in J. Benjamin, *Financial Law* (Oxford, OUP 2007), at p. 65.

14 To use the term which is central to Benjamin's thesis of financial law, Benjamin, ibid.

15 The obligations of the protection buyer and seller under a single name CDS are helpfully set out in diagrammatic form in D. Rule, 'The Credit Derivatives Market: Its Development and Possible Implications for Financial Stability', in *The Bank of England Financial Stability Review* (June 2001) p. 117, at p. 118. See also the detailed explanation as to 'What Are CDSs and How Are They Used?', in European Central Bank/Eurosystem, *supra* n. 7, at pp. 9-10.

16 For example, the European Central Bank/Eurosystem notes that the CDS market rose by 900% in the three years to the end of 2007 by which point it had a gross nominal value of $58 trillion (European Central Bank/Eurosystem, 'OTC Derivatives and Post-Trading Infrastructures' (September 2009), at p. 13).

17 Turner Review, *supra* n. 10, at p. 82.

The extraordinary complexity which evolved in this part of the OTC derivatives market has now been widely documented.[18] In particular, the use of CDS not in 'single-name' products[19] but as a 'building block'[20] in complex securitisations which create new instruments with 'synthetic' exposure to a portfolio of assets,[21] has become a hot topic for economists and other commentators considering the build-up to the financial crisis. For example, the proliferation of complex securitised products attracted detailed analysis in the Turner Review[22] and in 2009, the US Department of the Treasury stated that the risk characteristics of CDS used in asset-backed securitisations proved to be 'poorly understood even by the most sophisticated of market participants'.[23] Elsewhere, one (lay) author has suggested that no one understood these complex structured products at the time[24] and even the most expert financial services commentators have resorted to magic-referencing metaphors in their attempts to convey the complexity involved. Howard Davies, for instance, talks of the 'complex alchemy' of securitisations,[25] while Charles Morris (whose software company made tools for 'building and analysing … securitised asset pools'[26]) writes of how 'highly rated bonds magically materialize out of a witches' soup of very smoky stuff'.[27]

The Turner Review adds another dimension to concerns about this market by explaining that certain CDS contracts may themselves contribute to the insolvency risk of participants. This problem arises because a CDS may require parties to post

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[18] For example, see the 2009 European Central Bank/Eurosystem report which called CDS 'opaque credit risk instruments', European Central Bank/Eurosystem, *supra* n. 7, at p. 4. The European Commissioner for Internal Market and Services has commented of CDS that 'the opaqueness of these products leads to nasty surprises when things go wrong', European Commissioner for Internal Markets and Services Charlie McCreevy, 'Time for Regulators to Get a Better View of Derivatives: Statement on Reviewing Derivatives Markets before the End of the Year' (Brussels, 17 October 2008), Speech/08/538.

[19] Where CDS provide protection with respect to individual reference entities or assets, see Rule, *supra* n. 15, at pp. 118-119.

[20] Ibid., at p. 140.

[21] Ibid., at pp. 120-121.

[22] For example, see the discussion of the 'wave of financial innovation focused on the origination, packaging, trading and distribution of securitised credit instruments', in Turner Review, *supra* n. 10, at p. 14, and the subsequent discussion of complex products at pp. 22 and 28.

[23] US Department of the Treasury, 'Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation' (undated), at p. 47.

[24] The playwright David Hare concluded in a recent play (through which he 'seeks to understand the financial crisis') that '[*n*]*obody understood them*. Even Alan Greenspan … he didn't understand them… He said he had hundreds of people with PhDs working for him and they didn't understand them either', D. Hare, *The Power of Yes* (London, Faber and Faber 2009), at p. 34.

[25] H. Davies, 'With the Benefit of Hindsight: Lessons from the Credit Crisis for Banks, Regulators and Central Banks', speech, 10 November 2008, at p. 3, transcript available at: <http://www2.lse.ac.uk/aboutLSE/meetTheDirector/speechesAndLectures/home.aspx>.

[26] C. Morris, *The Trillion Dollar Meltdown: Easy Money, High Rollers and the Great Credit Crash* (London, PublicAffairs Ltd 2008), at p. xvi.

[27] Ibid., at p. 79.

collateral (i.e., certain types of assets[28]) during the life of the swap in order to address the increased credit risk of their counterparty. While the provision of collateral is an increasingly popular way of mitigating risk in the OTC markets,[29] the Turner Review notes that it may also 'produce disruptive procyclical effects'.[30] In other words, a vicious circle might be set off if party A is required to post collateral to its CDS counterparty once A's credit rating is downgraded. This is because providing collateral may undermine A's position further, triggering the requirement to post more collateral and so on, potentially pushing the party into insolvency. As the Committee on Payment and Settlement Systems (CPSS) put it in March 2007, 'linking margin requirements to downgrades in credit ratings in particular can give rise to extraordinary demands for collateral'.[31]

These risks crystallised in 2008 in the case of the near-collapse of the American Insurance Group (AIG). Many of AIG Financial Products' bespoke CDS with European banks included these 'credit rating triggers' for posting collateral. As a result, in the 15 days or so that followed its credit ratings downgrade on 15 September 2008, AIG Financial Products had to fund approximately US$32 billion of collateral calls and eventually had to be bailed out by the US Government.[32] This rescue was in part driven by the large net selling position the insurer had in the CDS market, as a counterparty to CDS of over US$400 billion.[33] Thus, had AIG collapsed in such a 'highly concentrated'[34] market, it would have left very many 'protection buyers' without the protection of their CDS contracts. As the European Central Bank/Eurosystem review put it, these counterparties would have 'instantly been forced to reappraise the value of the underlying corporate debt obligations…. It was widely considered that the expected knock-on effects for the already destabilised financial system would have been far-reaching'.[35]

Thus, given the 'increased contagion risk' within this deeply 'interconnected' market,[36] the vicious circle effect of credit rating triggers is particularly ominous.

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[28] The meaning of financial collateral is discussed further in section 3 of the paper.

[29] In 2000, US$200 billion was posted to support OTC derivatives exposures and there were 12,000 collateral agreements. By the end of 2005, US$1.3 trillion was posted and there were 110,000 collateral agreements: Committee on Payment and Settlement Systems, *New Developments in Clearing and Settlement Arrangements for OTC Derivatives* (Bank for International Settlements, March 2007), at p. 21.

[30] Turner Review, *supra* n. 10, at p. 82.

[31] Committee on Payment and Settlement Systems, *supra* n. 29, at p. 24.

[32] European Central Bank/Eurosystem, *supra* n. 7, at p. 30. See also the account of the aftermath of AIG's downgrading in Glass, *supra* n. 8, at p. S88.

[33] European Central Bank/Eurosystem, *supra* n. 7, at p. 29.

[34] Ibid., at p. 4.

[35] European Central Bank/Eurosystem, *supra* n. 16, at p. 11, at fn. 17, as well as European Central Bank/Eurosystem, *supra* n. 7, at p. 28 (describing AIG as 'too interconnected and too big to fail').

[36] European Central Bank/Eurosystem, *supra* n. 7, at pp. 4-5.

The global financial crisis and, in particular, the collapse of Lehman Brothers (another major participant in the CDS market) and near-collapse of AIG therefore drew regulatory attention to the build-up of systemic risk within the CDS market. In turn, the diagnosis of fragility and 'interconnectedness' within the CDS market jump-started the debate about extending CCP clearing. As Glass put it, and as the paper demonstrates below, 'the current financial crisis has been a game-changer for the prospect of CCP clearing of credit derivatives'.[37]

2.2 The prescription: worldwide proposals to extend CCP clearing

As the causes of the crisis were being studied by regulators around the world, a consensus quickly formed behind the proposal to extend CCP clearing to CDS. Significantly, the leaders of the G20 made a commitment to this reform relatively early on. The document produced at their April 2009 London Summit stated: 'We will promote the standardisation and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision.'[38]

The G20 followed up in September 2009 with a more detailed agreement. Notably, this document extended the types of OTC derivatives which were being targeted, stating that:

> All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.[39]

This broader proposal to require CCP clearing across all OTC derivatives markets has subsequently framed the international debate, as discussed below. For some regulators at least, addressing OTC derivatives generally rather than just CDS seems to have been driven by concern about producing overly technical rules which could be flaunted by using different classes of OTC products,[40] and it is now the approach adopted by each of the authorities considered below.

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[37] Glass, *supra* n. 8, at p. S81.

[38] G20, 'Declaration on Strengthening the Financial System' (London, 2 April 2009), under heading 'The Scope of Regulation', available at: <http://www.g20.utoronto.ca/2009/2009ifi.html>.

[39] G20, 'Leaders' Statement: The Pittsburgh Summit' (Pittsburgh, 24-25 September 2009), at paragraph 13, available at: <http://www.pittsburghsummit.gov/mediacenter/129639.htm>.

[40] For example, see European Commission, 'Ensuring Efficient, Safe and Sound Derivatives Markets: Future Policy Actions' (October 2009), COM(2009) 563, at p. 3 ('a comprehensive policy on derivatives is necessary in order to avoid market participants exploiting differences in rules, i.e. regulatory arbitrage').

While it is not the objective here to explore the regulatory dynamics behind different authorities' positions on the CCP prescription,[41] at the outset, the core content of the CCP prescription – mandating the use of private clearing houses which are already up and running in other parts of the OTC markets – may well have seemed a relatively uncontroversial and uncomplicated option for regulators grappling with a myriad of difficult reforms in the wake of the crisis.[42] However, implementation of this reform has proven challenging, highly technical and even controversial. Indeed, the debate over the last eighteen months or so has seen various national and international authorities begin to diverge and even openly disagree with one another about what this reform should look like in practice.

2.2.1 *The UK*

In a December 2009 publication, the FSA and HM Treasury reiterated that they 'strongly support' the extension of CCP clearing in the OTC derivatives markets.[43] However, amongst other reservations, the report expressed concern about the G20's proposals that 'all standardised derivatives contracts' be cleared, arguing that there is more to being 'clearing eligible' than a contract simply being made on standardised terms.[44] In particular, it drew attention to the need for there to be sufficient market liquidity to support clearing services. In support of this argument, the report noted that that clearing was already underway in the CDS market, but only for narrow classes of the most liquid products, leaving a 'large proportion' of important types of CDS unclearable.[45]

In June 2009, the Bank of England also expressed its support for the CCP prescription, though in tightly drafted terms which referred to the 'expansion of the use of central counterparties for the clearing of vanilla over-the-counter (OTC) instruments'.[46] Moreover, its report cautioned that in the case of CDS contracts particular care would be needed in the manner in which arrangements were set up, for example, to ensure that clearing houses manage their own risk effectively.[47] Indeed there is evidence that such challenges associated with CCP clearing for OTC derivatives have concerned the

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[41] For a helpful chronological discussion of the national and international proposals about extending CCP clearing for CDS, see European Central Bank/Eurosystem, *supra* n. 7, at pp. 76-79.

[42] For the European Commission alone, the legislative agenda includes the regulation of alternative investment funds and credit rating agencies, addressing risk management in financial institutions, new rules on financial conglomerates and so on.

[43] FSA and HM Treasury, *Reforming OTC Derivative Markets: A UK Perspective* (December 2009), at p. 11, available at: <http://www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf>.

[44] Ibid., at p. 11.

[45] Ibid., Annex 3 (Overview of CCP clearing for OTC derivatives markets), at pp. 1-2.

[46] Included in a list of areas where the 'Bank believes change is needed', Bank of England, *Financial Stability Report* (June 2009), at p. 36, available at: <http://www.bankofengland.co.uk/publications/fsr/2009/fsr25.htm>.

[47] Ibid., at p. 54.

Bank for some time[48] and overall its support for the CCP prescription has been more carefully put than that expressed by other authorities.

2.2.2 *The EU*

By contrast, at the EU level extending CCP clearing for all classes of OTC derivatives has been embraced with enthusiasm. The Internal Market and Services Commissioner stated in October 2008 that '[a]t $600 trillion the size of derivatives markets today are such that we cannot let this OTC market continue without adequate counter party clearing. This is particularly urgent for Credit Default Swaps'.[49]

Since then, there have been nearly two years of publications and consultations on the detail of the clearing proposal and other aspects of regulatory reform of the derivatives market, which have recently culminated in a proposal for a Regulation on OTC derivatives, central counterparties and trade repositories.[50] This proposed Regulation mandates CCP clearing for 'all OTC derivatives which are considered eligible' and which are entered into between financial counterparties or between a non-financial counterparty and a financial counterparty in certain circumstances.[51] It also lays down detailed new rules for the regulation of CCPs themselves[52] and requires all market participants to provide specified information about their OTC derivatives dealings to trade repositories or a competent authority.[53]

However, the proposed Regulation leaves open some fundamentally important operational issues. For instance, rather than set out in the face of the Regulation which contracts are to be affected, the new European Securities and Markets Authority (ESMA) is to be responsible for compiling the list of 'classes of derivatives'[54] which are 'eligible for the clearing obligation', and a mechanism is outlined for how the ESMA is to add new classes to this list.[55] Elsewhere in the proposed

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[48] See, for example, Bank of England, *Financial Stability Report* (April 2007), at p. 54, stating that 'there are several challenges associated with CCP in OTC, as compared with exchange-traded, derivatives markets', available at: <http://www.bankofengland.co.uk/publications/fsr/2007/index.htm>.

[49] McCreevy, *supra* n. 18.

[50] Proposal for a Regulation (EC) on OTC derivatives, central counterparties and trade repositories (Proposed Derivatives Regulation), COM(2010) 484/5; 2010/0250 (COD).

[51] Proposed Derivatives Regulation, Title II, Art. 3(1). Clearing will be required for contracts between a financial and non-financial counterparty unless the latter's transactions relate to its commercial activities or fall below a certain threshold, which is to be defined separately: Proposed Derivatives Regulation, Title II, Art. 7(2) and (4).

[52] Ibid., Titles III and IV.

[53] Ibid., Title II, Art. 6(1), and Title II, Art. 7(1) (non-financial counterparties only have to report positions above a threshold, which will be fixed separately).

[54] This term is defined as derivatives that 'share common, essential characteristics'. In a complex and innovative market, this may not prove to be a very practical definition. Proposed Derivatives Regulation, Title I, Art. 2(4).

[55] Ibid., Title II, Art. 4.

Regulation, the requirements imposed on parties entering into OTC derivatives which cannot be cleared remain surprisingly unspecific, although this is a fundamental aspect of the reform.[56]

The European Commission's previous publications on this issue have already attracted detailed scrutiny within the UK. In March 2010, the House of Lords European Union Committee (the 'Committee') scrutinised the Commission's Communications of July and October 2009 as part of its mandate to 'influence' and 'hold to account' the UK Government.[57] One of the issues on which the Committee heard expert evidence and eventually reported was the European Commission's recommendation that (in the words of the Committee's report) 'as many contracts as possible should be cleared through a central counterparty'.[58] On this matter, the Committee broadly endorsed the European Commission's approach but expressed concern on several critical points of detail.

By way of example, the House of Lords Committee's report expressed concern about various assumptions which had been made relating to the standardisation of OTC derivatives. While approving of industry and the European Commission's efforts to increase the use of standardised products, the report sought to emphasise that not all derivatives contracts could be standardised.[59] Drawing on evidence submitted to the Committee by a number of participants in this market, the report also challenged the assumption implicit in various G20 and Commission statements that there was symbiosis between contractual standardisation and clearing eligibility. Instead, the report found that not all standardised contracts could be cleared (because of other prerequisites, like a liquid market) while certain non-standard contracts could in fact be eligible for clearing.[60] In conclusion, the Committee recommended that the Government should encourage the Commission to 'define carefully' 'which contracts should be regarded as both standardised and appropriate for clearing'.[61] Bearing in mind the nature of the Regulation now proposed by the Commission which, as discussed above, reserves these decisions for the ESMA, it appears that the proposed legalisation will not yet have addressed the concerns of the Committee.

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[56] Ibid., Title II, Art. 8. Of course, it remains to be seen how or if these proposals change during the legislative process.

[57] House of Lords European Union Committee, *The Future Regulation of Derivatives Markets; Is the EU on the Right Track? Report with Evidence*, HL Paper 93 (10th Report of Session 2009-10, 31 March 2010), at p. 2 (hereafter, the 'HL EU Committee Report'). This report saw the Committee scrutinise two Communications published by the European Commission: European Commission, 'Ensuring Efficient, Safe and Sound Derivatives Markets' (July 2009), COM(2009) 332, and European Commission, 'Ensuring Efficient, Safe and Sound Derivatives Markets: Future Policy Actions' (October 2009), COM(2009) 563.

[58] Ibid., at p. 26.

[59] Ibid., at p. 30.

[60] Ibid., at p. 31. Discussed further in section 3 below.

[61] Ibid., at p. 31.

2.2.3 *The US*

While the goal is that new EU rules should be 'in place and operational' by the end of 2012,[62] sweeping financial reform regulation has already been passed in the US in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[63] Amongst its many provisions, the Act provides for compulsory CCP clearing in the OTC derivatives markets. Title VII ('Wall Street Transparency and Accountability', hereafter 'Title VII') is the main source of the various new rules for the OTC derivatives markets, though there are several provisions elsewhere in the Act that will also have a significant impact on participants in these markets.[64]

Title VII deals separately with 'swaps' which are regulated by the Commodity Futures Trading Commission (CFTC) and 'security-based swaps' which are the responsibility of the Securities and Exchange Commission (SEC) (together referred to here as the 'Authorities').[65] Though the two categories of swaps are dealt with separately in the Act, many of the new rules are similar in both cases and, in any event, the Authorities are required to consult with each other and with the prudential regulators to coordinate their activities.[66] A detailed review of the provisions of the Act is outside the scope of this paper. However, some of the main provisions as regards the OTC derivatives market are as follows: it will be unlawful to engage in either type of swap unless it is submitted for clearing if it 'is required to be cleared';[67] all swaps, regardless of whether they are to be cleared or not, will be subject to reporting requirements;[68] and parties which are 'Swap Dealers', 'Major Swap

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62 European Commission, 'Commission Proposal on OTC Derivatives and Market Infrastructures – Frequently Asked Questions' (15 September 2010) MEMO/10/410.

63 H.R. 4173, signed into law by President Obama on 21 July 2010 (hereafter the 'Dodd-Frank Act'). The scope of the Act is captured by its long title: 'An Act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.'

64 For example, the new limits on banks' proprietary activities in the Dodd-Frank Act, Title VI ('Improvements to Regulation of Bank and Saving Association Holding Companies and Depository Institutions').

65 Though these terms are defined in existing legislation, the Act provides that the Authorities 'further define' certain key terms used in Title VII, including swap and security-based swap: Dodd-Frank Act, s 712(d).

66 Dodd-Frank Act, s 712(a)(1) and (2).

67 As regards swaps: Dodd-Frank Act, s 723(a), inserting a new Commodity Exchange Act (7 U.S.C. 2), s 2(h)(1)(A). As regards security-based swaps: Dodd-Frank Act, s 763, inserting a new Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), s 3C(a)(1).

68 As regards swaps: Dodd-Frank Act, s 727, inserting a new Commodity Exchange Act (7 U.S.C. 2(a)), s 2(a)(13). As regards security-based swaps: Dodd-Frank Act, s 763, inserting a new Securities Exchange Act of 1934 (15 U.S.C. 78m), s 13(m).

Participants' or 'Major Security-Swap Participants' entering into non-cleared swaps will have to meet capital requirements and post initial and variation margin.[69]

For the purposes of this discussion, the most relevant new rule in Title VII is that which provides for mandatory clearing of both swaps and security-based swaps. Importantly, however, this requirement is qualified in several ways in the Act, two of which are discussed here.

First, Title VII does not make it mandatory to clear every type of OTC derivative. In fact, both the Authorities and clearing houses have input into deciding for which products or classes of products it will be required. The Authorities have responsibility for conducting reviews 'on an ongoing basis' of those products for which clearing is required. The clearing agencies have input as they can submit products which they want to clear to the Authorities for a review, which will be conducted with reference to a list of factors including the effect on systemic risk, trading liquidity and so on. The Act provides that all products currently being cleared are deemed submitted for review by the Authorities. Crucially, though, the Act makes it clear that clearing houses cannot be forced by the Authorities to clear a product that would threaten their 'financial integrity'. There are also back-up provisions in case clearing of a particular product is required but no clearing house will take it, including that the Authorities have the power to require the parties to post collateral, on the basis of 'the public interest'.[70]

The second qualification to the mandatory rule is provided by a series of exemptions. These include the 'end-user' exemption for parties that are not a 'financial entity', which are using swaps to hedge or mitigate commercial risk and which notify the CFTC or SEC about how they meet their financial obligations in relation to the swaps.[71] Again, various important definitions included in this exemption have been reserved for later rule-making by the Authorities (for example, the definition of a 'substantial position' that informs the definition of a 'Major Swap Participant', which is one sort of 'financial entity'[72]).

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[69] The meaning of which is explained in section 3 of the paper. As regards swaps: Dodd-Frank Act, s 731, inserting new Commodity Exchange Act (7 U.S.C. 1 et seq.), s 4s(e)(2)(A) and (B). As regards security-based swaps: Dodd-Frank Act, s 764, inserting new Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), s 15F(e)(2)(A) and (B).

[70] As regards swaps: Dodd-Frank Act, s 723. As regards security-based swaps: Dodd-Frank Act, s 763.

[71] As regards swaps: Dodd-Frank Act, s 723, inserting a new Commodity Exchange Act (7 U.S.C. 2), s 2(h)(7). As regards security-based swaps: Dodd-Frank Act, s 763, inserting a new Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), s 3C(g).

[72] See definition of 'Major Swap Participant', referencing 'substantial position' at Dodd-Frank Act, s 721, referenced in the definition of 'financial entity' at Dodd-Frank Act, s 723, inserting a new Commodity Exchange Act (7 U.S.C. 2), s 2(h)(7).

Overall, this Act is, in the words of one law firm, 'massive'.[73] Title VII alone represents a major overhaul of US financial regulation and, when combined with provisions elsewhere in the Act, it will dramatically change the regulatory landscape of the OTC derivatives markets. However, as with much of the rest of the Act, definitions of fundamentally important terms, key details about how the provisions will actually work in practice and secondary rules which are needed to flesh out the new regulatory framework have been reserved for the Authorities and other regulators. For that reason, the debate about how the CCP prescription should work in practice still has a long way to go, even in the US.

2.2.4 *The CCP prescription so far*

The story of the CCP prescription so far can therefore be characterised as one which started with high-level principles expressed by authorities keen to respond promptly to the weaknesses which the financial crisis revealed in the CDS market. Since then, it is possible to track the emergence of a broad, international consensus behind extending CCP clearing across the OTC derivatives markets. However, as the debate has worn on, the sheer complexity of implementing new rules has caught up with legislators and has triggered divergence and even disagreement on a number of technical issues that promise to be critical to the effectiveness of reform.[74] As a result, fundamental details about how this reform will work in practice still remain open, and even with the Dodd-Frank Act now signed into law in the US, it remains true to say that no jurisdiction has yet set down clear rules on fundamental issues such as which products will and will not be required to be cleared.

There are clearly multiple drivers behind this complexity, including the fact that the debates are proceeding across different national and transnational jurisdictions simultaneously. But while the challenges of international coordination have been widely acknowledged,[75] there has been a less coherent approach within the debates to

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[73] DLA Piper, 'Dodd-Frank Alert: Regulators Take Centre Stage' (2010), at p. 1, available at: <http://www.dlapiper.com/files/upload/dodd-frank-act.pdf>.

[74] While the rest of this paper concentrates on the private law dimensions of the CCP prescription and discusses how this analysis might inform the regulatory debate, there are separate questions to be explored about the extent to which institutions responsible for reform are equipped to tackle questions of private law. The issue of institutional competence in respect of the private law aspects of the financial markets merits further research in light of current regulatory reform projects, but is beyond the scope of this paper.

[75] In particular, as regards the importance of a coordinated approach to standard setting for CCPs. International coordination is facilitated in this respect by the work of the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organisation of Securities Commissions (IOSCO), which are currently engaged in an ongoing review (at the G20's request) of their recommendations for CCPs in light of the proposed extension of CCP clearing.

an equally important source of complexity: the fact that the CCP prescription incorporates into legislation CCP clearing, which is a private sector owned and operated risk management device, and a product of various private law techniques.

Of course, certain aspects of the private nature of CCPs have had an impact upon the public debates about the CCP prescription. Expert witnesses from clearing house companies, trade associations, end-users and dealers gave detailed evidence to the House of Lords about how their businesses work, making a considerable impact on the Committee's final report.[76] The two public consultations by the European Commission sought the views of hundreds of parties from the private as well as public sectors.[77] Nonetheless, I argue below that the public debates would benefit from addressing the private nature of CCPs upfront and in a more coherent way, rather than dealing with the implications as part of a long list of other issues. To put it another way, the debates described in this part of the paper have tended to centre on the question of how this particular reform should work in practice, at the expense of considering in detail the legal nature of the CCP device that the public sector is seeking to incorporate into legislation. As discussed in the next part of the paper, the nature of CCP clearing can be usefully explored as a matter of private law, and the benefit of this approach is that it helps to systematise the various problems thrown up in the public debates about this reform thus far.

3. A PRIVATE LAW PERSPECTIVE ON CCP CLEARING

CCP clearing works because of the interaction of various private law techniques. This means that taking into account the private law perspective is an important part of assessing the function and capacity of the device which the public sector is seeking to incorporate into regulatory reform.

The European Commission has recently emphasised the need for global coordination in terms of these reforms, referencing the awaited review by CPSS/IOSCO. The same document also mentions the OTC Derivatives Regulators' Forum which 'was established to promote cooperation between regulators': European Commission Proposal on OTC Derivatives, *supra* n. 62. The House of Lords European Union Committee has welcomed the Commission's 'acknowledgement of the need to develop a coordinated global approach in line with the work of CPSS and IOSCO': HL EU Committee Report, *supra* n. 57, at p. 42.

US legislation also acknowledges the need for international coordination. The Dodd-Frank Act, s 722, addresses the extraterritorial application of the legislation (but leaves key issues open). The Dodd-Frank Act, s 719(c), requires the CFTC and SEC within 18 months of the Act to jointly conduct a study into swap regulation, clearing house and clearing agency regulation in the US, Asia and Europe identifying 'areas of regulation that could be harmonized'.

[76] See HL EU Committee Report, *supra* n. 57, at p. 46, Appendix 2 (List of Witnesses).

[77] As explained in European Commission, 'Explanatory Memorandum to the Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories', COM(2010) 484/5, 2010/0250(COD), at pp. 3-4.

3.1 Private law and market-generated 'legal devices'

As Waddams notes, 'Anglo-American law has claimed many merits, but linguistic and conceptual precision are not among them'.[78] However, in the financial markets literature, 'private law' typically refers to the legal norms used by private actors to 'create or alter private rights'[79] as between themselves. This can be distinguished from the legal norms imposed on them 'from outside' by public actors such as legislators. Though the distinction between private and public actors may be a particularly artificial one in the context of what Black has described as the highly 'decentred' and 'hybrid' context of financial regulation,[80] it is possible to be more precise when addressing a particular sector of the markets. For example, in his critique of the role of 'private law' within the fragmented regulation of the derivatives market Partnoy discusses the use of the standard form contracts created by the trade association ISDA[81] and the effects on derivative counterparties' rights of the disclaimers therein.[82]

Studies of private law in the financial markets are often preoccupied with the nature of the contracts, or even individual contractual terms, which market participants enter into with one another; hence the large literature about standard form contracts or boilerplate drafting in the sovereign debt,[83] syndicated loan[84] and OTC derivatives markets.[85] Valuable studies have highlighted how market actors use sophisticated standardised contracts and other drafting techniques to mitigate credit

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[78] S. Waddams, *Dimensions of Private Law: Categories and Concepts in Anglo-American Legal Reasoning* (Cambridge, Cambridge University Press 2003), at p. 1.

[79] Black's description of legal norms: J. Black, 'Mapping the Contours of Contemporary Financial Services Regulation', 2 *Journal of Corporate Law Studies* (2002) p. 253, at p. 256.

[80] Black explores the 'hybridity' of decentred financial regulation by focusing on the 'extremely wide range of actors who are or potentially could be involved in the regulatory process', Black, ibid., at p. 262.

[81] F. Partnoy, 'The Shifting Contours of Global Derivatives Regulation', 22 *University of Pennsylvania Journal of International Economic Law* (2001) p. 421, at p. 479.

[82] Ibid., at pp. 478-481.

[83] For example, A. Gelpern and M. Gulati, 'Public Symbol in Private Contract: A Case Study', 84 *Washington University Law Review* (2006) p. 1627; C. Bradley, 'Private International Law-Making for the Financial Markets', 29 *Fordham International Law Journal* (2005) p. 127, at pp. 160-164; and the first case study in S. Choi and G. Mitu Gulati, 'Contract as Statute', 104 *Michigan Law Review* (2005-6) p. 1129, at pp. 1133-1139.

[84] For example, Bradley, ibid., at pp. 166-170; Benjamin, *supra* n. 13, at pp. 157-170.

[85] For example, Partnoy, *supra* n. 81; Murray, *supra* n. 12; A. Riles, 'The Anti-Network: Private Global Governance, Legal Knowledge, and the Legitimacy of the State', 56 *American Journal of Comparative Law* (2008) p. 605; J. Golden, 'The Future of Financial Regulation: The Role of the Courts', in I. MacNeil and J. O'Brien, eds., *The Future of Financial Regulation* (Oxford and Portland, Oregon, Hart 2010) (discussing the implications of post-crisis litigation for markets which use standardised contracts, making particular reference to the ISDA documentation); and Choi and Gulati, *supra* n. 83, at pp. 1139-1144.

risk when they are relatively unprotected by public sector rules,[86] to send a signal to public authorities and other non-parties[87] and otherwise facilitate international transactions.[88]

But there is more to private law in the financial markets than the skilful use of contracts and, in practice, parties often pursue their goals by deploying a number of legal techniques (such as asset-backing and netting) in combination with one another. For example, collateralisation in the OTC markets, as studied by Riles in her anthropological work on Japanese derivatives dealers, turns on the interaction of standardised contracts with the transfer of rights in property which together enable the parties to bypass national bankruptcy laws on the insolvency of a derivatives counterparty.[89] Other examples of the deployment of interacting private law techniques are found in the use of special purpose vehicles in securitisation transactions (involving asset-backing, limited liability companies and trust structures),[90] close-out netting as used in master agreements (standardised contracts, novation[91]) and, most importantly for these purposes, central counterparty clearing. I collectively refer to these market-generated products of various private law techniques as 'legal devices'.

The relationship between these interacting legal techniques and the capacity of these legal devices is significant. These legal techniques do not simply explain how legal devices facilitate market activity but they also determine the inherent features of the devices, including their benefits, limitations and weak spots. Thus, studying the underlying legal techniques in detail is an important part of assessing the capacity of these private sector legal devices and it is especially relevant when, as in the case of the CCP prescription, such a device is to be incorporated into financial regulation by the public sector with the intention that it perform various regulatory functions.

3.2 The private law techniques underlying CCP clearing

The operation of CCP clearing turns on the interaction of a number of different legal techniques, which in turn define its capacity. The most important of these are considered below, along with the implications for the CCP prescription.

The specific focus in the following discussion is on English law, though of course the worldwide reforms discussed in the preceding part of the paper above will implicate CCPs in numerous jurisdictions, operating on the basis of different

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86 Benjamin, *supra* n. 13, at pp. 233-240 and 256-7.

87 Gelpern and Gulati, *supra* n. 83, at pp. 1712-1714.

88 Riles, *supra* n. 85.

89 Ibid., at pp. 610-612.

90 As discussed in D. McBarnet, 'Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis', in MacNeil and O'Brien, eds., *supra* n. 85, at pp. 70-72.

91 Murray, *supra* n. 12, at pp. 291-293. See also the discussion of close-out netting in the context of the repo markets, in Benjamin, *supra* n. 13, at pp. 320-321.

governing law. However, it is submitted that the analytical approach developed here on the basis of an analysis of English law is applicable to CCPs in other jurisdictions. Meanwhile, the inevitable conflict of laws dimension to the CCP prescription, arising from the cross-border nature of the dealings that policymakers seek to regulate, is discussed briefly in section 4 of the paper.

3.2.1 *Novation and standardisation*

Perhaps the most fundamental legal point about CCP clearing is that the contracts in question are between the CCP and the members of the clearing system rather than between members themselves. This arrangement lies at the heart of the operation of CCP clearing, and it is reflected in the European Central Bank's definition of a 'central counterparty' as:

> An entity that interposes itself, in one or more markets, between the counterparties to the contracts traded, becoming the buyer to every seller and the seller to every buyer and thereby guaranteeing the performance of open contracts.[92]

Depending on the structure of the clearing system in question, this outcome may be achieved either by members A and B contracting in the first instance with the CCP, or by A and B contracting with each other initially, with this contract then being replaced by new contracts between each member and the CCP.[93] This latter arrangement depends on the legal technique of novation, which cancels one contract and replaces it with another. Novation is notable as the only means in English law whereby the benefits and burdens of a contract may effectively be transferred to a third party.[94] Its capacity to bring about this 'clean break' allows the bilateral contract between A and B to be replaced by parallel contracts between A and the CCP and B and the CCP, with no rights and obligations (and therefore no counterparty risk) remaining between A and B.

That the CCP becomes the 'buyer to every seller and the seller to every buyer' underpins some of the most important benefits of the CCP prescription. As discussed further below, it means that the CCP can act as a shock absorber on the insolvency of a market participant. It also means that the CCP will be in a position to collect critical information about the market. As explained above, the opacity of the CDS market to date has become a particular cause of concern for regulators. As the FSA

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[92] European Central Bank/Eurosystem, *Glossary of Terms Related to Payment, Clearing and Settlement Systems* (December 2009), at p. 4.

[93] See the detailed discussion of how these two alternatives work in a variety of different clearing systems provided by LCH in M. Yates, 'UK Settlement', in Blair and Walker, eds., *supra* n. 2, at pp. 321-324.

[94] For a discussion of a number of different English law techniques of transfer in the context of the financial markets, including novation, see Benjamin, *supra* n. 13, at pp. 528-531.

and HM Treasury have recently put it: '[I]mperfect market information also limits a regulator's ability to monitor systemic risks and act to mitigate them'.[95] In order to capitalise on this information-gathering function, the Dodd-Frank Act discussed above expressly provides for CCPs (as well as trade repositories and other market participants) to be required to furnish information to regulators to help them detect and deter market abuses.[96]

To facilitate a CCP acting as buyer to every seller and vice versa (whether through novation or otherwise) the contracts being cleared would normally be in a standardised form. In terms of the underlying legal techniques, this can be understood as contractual standardisation coming together with novation to facilitate the process of clearing.

The debate about the CCP prescription in the OTC derivatives market has tended to proceed on the basis of three assumptions about contractual standardisation: that greater standardisation is a good thing; that only standardised OTC derivatives products can be cleared; and that all standardised products should be forced into a clearing system. However, a closer look at what is involved in CCP clearing and at the legal technique of contractual standardisation shows that qualifications should be made to each of these assumptions.

First, the assumption that greater contractual standardisation in the OTC markets is a good thing. Across the debates since the crisis broke there has been widespread approval of increasing the use of standardised OTC derivatives documentation. As the FSA and HM Treasury have noted approvingly, ISDA is currently leading industry efforts to increase standardisation in particular OTC derivatives markets including CDS.[97] Robert Pickel, the CEO of ISDA has observed that the 'natural evolution of successful derivative products is in the direction of greater standardisation'[98] and (writing before the crisis) Walker also described standardisation in the OTC markets as a 'useful device'.[99]

However, the implications of the wider use of standardised contracts deserve to be discussed more thoroughly as part of the debate about extending CCP clearing. As a practical point, the law firm Ashurst LLP raises the point that the meaning of 'standardised' will be uncertain in practice, which may result in participants seeking legal opinions that their particular 'contractual arrangement' qualifies and should

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[95] FSA and HM Treasury, *supra* n. 43, at p. 6.

[96] For example, as provided for in the Dodd-Frank Act, s 725(c), inserting a new Commodity Exchange Act (7 U.S.C. 7a-1(c)), s 5b(c)(2)(K) and (L), addressing the record-keeping and disclosure obligations of clearing houses. This provides that certain information is to be made public and disclosed to the CFTC, including the terms and conditions of each contract cleared, margin-setting methodology and daily settlement prices and volume.

[97] FSA and HM Treasury, *supra* n. 43, at p. 9.

[98] Pickel, *supra* n. 6, at p. S72.

[99] G. Walker, in Blair and Walker, eds., *supra* n. 2, at p. 61.

therefore be cleared by a CCP, potentially passing on 'unmanageable risk'.[100] This raises the possibility of regulatory arbitrage by parties trying to get their contract cleared (rather than seeking to circumvent clearing requirements, which is the usual worry in the debates). Moreover, if the public sector mandates or otherwise works to increase the use of standardised documentation, this will have a knock-on effect on the regulatory role played by the trade associations or other actors responsible for producing it. Indeed, some academics have already expressed concern about the processes behind standard form documentation in the financial markets. For example, looking from the perspective of transparency and the processes of law-making, Bradley has expressed concern that standard form contracts 'can constrain or limit regulation' and that the 'processes which produce [them] are private and opaque to outsiders'.[101]

The contract law literature also helps to shed light on the use and properties of standardised contracts in the financial markets[102] and provides a useful insight into the potential implications of increasing standardisation in this case. In particular, Collins has shown how contractual standardisation is a powerful tool which allows autonomous 'club markets' to transform 'contracts into things'[103] (or 'objects of property'[104]), thereby making possible a trade in futures contracts. However, he also shows how this use of standardised contracts necessarily excludes the 'unusually reflexive' qualities of contract law 'as a regulatory mechanism'.[105] This means, for example, that parties may not negotiate to resolve disputes on their own terms. In other words, market participants necessarily sacrifice a wealth of rights afforded by the private law system in return for the benefits of participating in autonomous, organised markets.[106] In the context of the OTC derivatives markets, some of those rights (for example, which allow parties to hedge specific risks, tailoring their contracts by reference to the nature and dates of exposure they are facing) may well be very important for certain participants. There has been some discussion relating to these issues in the debate about the CCP prescription so far; for example, it has been argued that the CCP prescription represents 'further specific restrictions on derivative transactions' and impacts upon parties' freedom of contract.[107] However,

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100 See the Memorandum by law firm Ashurst LLP, providing evidence to the House of Lords European Union Committee, reproduced at HL EU Committee Report, *supra* n. 57, p. 52, at p. 55.

101 Bradley, *supra* n. 83, at p. 174.

102 See also the work of Riles, who explores in some detail how standard contracts are used in practice, for example, contrasting the socio-legal view that they represent 'the production of new legal regimes through the routinization of work and professional roles' with the law and economics perspective that they represent 'costs savings', Riles, *supra* n. 85, at p. 624.

103 H. Collins, *Regulating Contracts* (Oxford, Oxford University Press 1999), at pp. 209-222.

104 H. Collins, 'Regulating Contract Law', in C. Parker, et al., eds., *Regulating Law* (Oxford, Oxford University Press 2004), at p. 25.

105 Ibid., at p. 24, discussing Collins, *supra* n. 103, at pp. 65-69.

106 Ibid, at p. 26.

107 For example, in the Memorandum by Ashurst LLP, *supra* n. 100, at p. 52.

the principal focus to date has been those parties who will continue to require bespoke products (as discussed, for example, by HM Treasury in its evidence to the House of Lords Committee[108]) rather than the constraints that standardised contracts impose on parties using them.

The second assumption commonly made in the debate about the CCP prescription is that only standardised contracts can be cleared. For example, the European Central Bank/Eurosystem has stated that, 'to be eligible for clearing a product must, as a minimum, be liquid, have price transparency and be standardised'.[109] However, evidence put to the House of Lords European Union Committee by LCH.Clearnet made it clear that certain non-standardised contracts could be accepted for clearing by a clearing house, as is the case with their portfolio of swaps.[110] Thus, standardisation is not an essential prerequisite for CCP clearing. Using standardisation as a shorthand to describe which contracts can or should be cleared is therefore an oversimplification; rather, standardisation is better understood as one of several factors affecting the decision of private clearing houses about the sorts of risks they are willing and able to manage.[111]

The third common assumption is that the CCP prescription should involve forcing all standardised products onto clearing. This goes back to the G20's statement that 'all standardized (sic) OTC derivatives' should be cleared, which has been endorsed by the European Commission. However, considering this proposition from the point

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[108] 'Non-financial firms, in particular, have a legitimate need to transfer their risks using bespoke products.' See Supplementary Letter from HM Treasury, HL EU Committee Report, *supra* n. 57, p. 17. Airlines, for example, use derivatives to address the risk associated with fluctuating aviation fuel prices. See the Memorandum by British Airways, providing evidence to the House of Lords European Union Committee, reproduced at HL EU Committee Report, *supra* n. 57, pp. 68-71.

[109] European Central Bank/Eurosystem, *supra* n. 7, at p. 79.

[110] Transcript, Examination of Witnesses R. Liddell (Chief Executive) and R. Cunningham (Director of Public Affairs) LCH.Clearnet, HL EU Committee Report, *supra* n. 57, pp. 46-7, Q126. (LCH.Clearnet's witnesses stated that it is 'easier' to clear contracts if they are standardised but non-standardised contracts could be accepted for clearing too, as LCH.Clearnet does with its swap portfolio which was described by Mr Liddell as 'simple and vanilla in its risk but not standardised in terms of transactions').

[111] LCH.Clearnet has stated that 'the fundamental requirement for eligibility is that the CCP can manage the default of a participant through the implementation of both its risk management and default management policies in a way that controls systemic risk'. It has stated that there are four main considerations for the clearing house in this regard, which can be summarised as: the assurance of market liquidity; availability and reliability of market prices; CCP default management procedures; and cost of providing clearing service and maintaining risk management structures. See Memorandum by LCH.Clearnet, providing evidence to the House of Lords European Union Committee, reproduced at HL EU Committee Report, *supra* n. 57, p. 39, at p 41.

The Future and Options Association (FOA) gave the following as example of factors affecting clearing eligibility: 'pricing transparency, liquidity, volatility, risk complexity, valuation capability and the risk management capacity of the CCP'. See Memorandum by the FOA, providing evidence to the House of Lords European Union Committee, reproduced at HL EU Committee Report, *supra* n. 57, p. 88, at p 90.

of view of CCP clearing systems shows that if this proposal were taken literally, it could have an adverse effect on the stability and risk management of clearing houses. As the House of Lords Committee put it: 'CCPs are privately owned companies, which can currently refuse to clear products where they feel they cannot manage the associated risk and this system has worked well even during the financial crisis'.[112] Being able to select which products to clear goes to the heart of the risk management practised by CCPs and this might mean that some standardised contracts are not in fact clearable. If legislation were to force CCPs to clear, for example, illiquid but standardised products, this could adversely affect their ability to manage their own risk. In short, CCP clearing systems could become more vulnerable if their own decisions about which contracts to clear were overridden by public sector rules. Weakening the resilience of CCPs would, of course, be disastrous and ultimately risk defeating the object of this legislative exercise.

Thus, the legal technique of standardisation is central to the debate about the CCP prescription, because of how CCP clearing works as a matter of law. However, certain assumptions by policymakers have oversimplified the relationship between clearing eligibility and standardisation. An overly blunt legislative definition of those products which must be cleared could threaten the autonomy of CCPs to choose what to accept for clearing. While it will be a significant weakening of the original goal to clear all standardised contracts, the legislative definition of the products that must be cleared must provide (as US legislation does) for the CCPs to retain control of which products they clear. Overall, a more nuanced approach to 'clearing eligibility' than has been shown by some authorities to date is going to be necessary for CCPs to work safely and effectively within a new legislative framework.

3.2.2 *Financial collateral and asset-backing*

Benjamin describes the provision of financial collateral as 'the use of financial assets in security, quasi-security or title transfer collateral arrangements'.[113] In turn, she collectively describes these legal techniques as asset-backing, whereby 'the credit exposure of the position taker is addressed by earmarking particular assets to meet its claims'.[114] Asset-backing is an important feature of CCP clearing as members are required to post financial collateral as margin to cover their exposures to the CCP. As discussed above, the novation of members' contracts to the CCP means that if one member were to default, the CCP would still owe the corresponding obligations to other members. Thus, this collateral is a vital first (but not only[115]) line of defence

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112 HL EU Committee Report, *supra* n. 57, at pp. 31-32.

113 Benjamin, *supra* n. 13, at p. 445.

114 Ibid., at p. 331.

115 Other resources which could be deployed in the event of a member's insolvency include the CCP's default fund and the capital resources of the CCP itself, as discussed at HL EU Committee Report, *supra* n. 57, at p. 29.

for the CCP in the case of the failure of a market participant. LCH.Clearnet, for example, reported to the House of Lords Committee that it held 'initial margin' (explained below) totalling £50 billion. Moreover, it reported that its holding of $2 billion of initial margin in respect of Lehman Brothers easily absorbed the outstanding obligations owed to counterparties on the bank's default in 2008.[116]

Looking at the legal nature of members' asset-backing obligations more precisely, members are required to post collateral as transactions are registered (initial margin) and then from time to time as provided for by the clearing house rules (variation margin).[117] Yates notes that under the LCH Rules, initial margin may be provided in the form of various assets identified in LCH's General Regulations, but variation margin must be provided in the form of cash.[118] The significance of posting collateral in cash is not only, as Benjamin notes, that it is the most sought after form of financial collateral and therefore highly in demand[119] but also that upon its transfer to the collateral-taker (the CCP), the collateral provider becomes a creditor of the CCP.[120] Moreover, the CCP's enforcement of rights against the cash collateral will be by way of set off, as between the credit balance of the member's account (the debt the CCP owes to the member) and the member's liabilities (its debt to the CCP).[121]

In contrast, when members post collateral in the form of non-cash assets, the member may retain property rights in the collateral. In the LCH context, for example, Yates describes how members provide collateral in the form of non-cash assets (e.g., securities) by transferring the assets to an account with LCH and granting LCH a security interest, i.e., LCH takes a first fixed charge to secure the member's performance of its obligations.[122] This arrangement means that the member retains property rights in the asset which are, by definition, enforceable against third parties and survive the collateral-taker's insolvency.[123] There is a clear contrast between the

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116 Ibid., at p. 29.

117 For a further discussion of 'initial margin' and 'variation margins', see P. Wood, *English and International Set-Off* (London, Sweet & Maxwell 1989), at p. 171 (noting that variation margins may be calculated daily or with greater frequency). The Turner Review found that the obligation in AIG's derivative contracts to post more variation collateral as its credit worthiness fell contributed to the group's 'downward spiral' in September 2008. See Turner Review, *supra* n. 10, at p. 22.

118 Yates, *supra* n. 93, at p. 325.

119 Benjamin, *supra* n. 13, at p. 450.

120 Yates, *supra* n. 93, at p. 325. The implications of this point in the context of global custody are discussed in J. Benjamin and M. Yates, *The Law of Global Custody* (London, Butterworths LexisNexis 2002), at p. 25.

121 Yates, *supra* n. 93, at p. 325.

122 Ibid.

123 See the detailed discussion of the law of property in the context of the financial markets in Benjamin, *supra* n. 13, at chapter 16.

The distinction between a prime broker's legal interest in clients' securities and cash was the backdrop to a dispute about what happened to securities which had 'leaked' into cash at the time of the prime broker's insolvency in *In the Matter of Lehman Brothers International Europe (in administration), Anthony Victor Lomas and ors.* v. *RAB Market Cycles (Master Fund Limited) and anr.* [2009] EWHC 2545 (Ch).

position of the member in this case and the position if it has provided cash collateral, where it would merely have personal rights as an unsecured creditor of the CCP.

The legal effects flowing from the use of various types of financial collateral and asset-backing techniques may not, traditionally, have been at the forefront of market participants' minds. However, the insolvency of Lehman Brothers International (Europe) (LBIE), an important prime broker holding the assets of many hundreds of counterparties,[124] has recently brought home the enormous implications of such legal details, albeit in a different context within the markets. In the immediate aftermath of LBIE's collapse, certain funds resorted to applying (unsuccessfully) for a court order seeking information about their assets, on the basis that they had been brought to the brink of ruin by the delay in the return of their assets while administrators tried to untangle the highly complex arrangements used by LBIE.[125] The extension of CCPs to new and vast areas of the market will mean that these potentially complex legal details will become even more significant for the markets.

Moreover, these asset-backing requirements may have an adverse economic effect on 'thinly capitalised' market participants, and PFI/PPP project companies are cited in this context by the FSA and HM Treasury.[126] So, on top of the legal risks which collateralisation represents, the extended use of CCP clearing will also mean more pressure on good quality financial collateral and the possibility of some parties having to borrow to meet asset-backing requirements.

3.2.3 *Netting: non-insolvency*

CCP clearing allows all of members' positions to be netted in the ordinary course of events, i.e., when no members are insolvent. One benefit of this is that gross sums due between parties are replaced by a single net sum (owed to or by the CCP). This reduces parties' exposures and takes the pressure off the settlement infrastructure. The importance of this latter, operational point should not be underestimated. As Wood notes, in the late 1960s and early 1970s: '[S]everal major United States brokerage firms failed primarily because of their inability to process transactions. If buys and sells and corresponding payments can be netted, millions can be reduced to thousands.'[127]

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[124] As noted in a recent Court of Appeal decision, the administrators of Lehman Brothers International Europe have written to 1,707 account holders who 'are thought to have potential claims against LBIE for the return of trust property', *In the Matter of Lehman Brothers International (Europe) (in administration)* [2009] EWCA (Civ) 1161 [8] (Patten LJ).

[125] As described at *In the Matter of Lehman Brothers International (Europe) (in administration)* [2008] EWHC 2869 (Ch) [13], citing the (anonymised) applicants' evidence that 'if the present situation continues for very much longer the funds are virtually certain to lose the confidence of their investors so that they will suffer revenue impairment… In summary, the funds will suffer economic loss, and so will their investors unless their positions are transferred soon.'

[126] FSA and HM Treasury, *supra* n. 43, at pp. 13-14.

[127] Wood, *supra* n. 117, at p. 170.

It is the case that, outside insolvency, parties could achieve similar effects without the use of a CCP through careful contractual drafting. For example, parties may provide for multilateral netting, where all of the rights and obligations between multiple parties are replaced by a single sum owed to or by each party. Wood describes this as the 'non-mutual set-off of claims' noting that the objective is 'to minimise the number of actual transfers and circuity of contracts'.[128] This contractual multilateral netting may be supported by a clearing house, though in this case its function would simply be to calculate the single sums owed to or by each party at the end of the payment cycle. In *British Eagle International Airlines Ltd.* v. *Compagnie Nationale Air France*,[129] this sort of contractual multilateral netting was deployed by member airlines which owed money to and were owed money by each other because, for operational convenience, they sold tickets for services to be provided by other airlines. Facilitated by a clearing house (IATA), the arrangements brought considerable operational advantages: in one year, only nine per cent of gross sums owing between the members actually fell to be paid.[130]

If netting may be effected by the terms of the contracts between parties, why is CCP clearing useful? In addition to the operational advantages mentioned already, the main reason is that multilateral netting arrangements provided for in contracts will not survive the insolvency of one of the participants, as was famously held in *British Eagle*. In other words, as Wood says of such contract-based multilateral netting arrangements 'there is no objection to this as long as all parties are solvent'.[131] Novating to the CCP overcomes this problem.

3.2.4 *Netting: insolvency of a CCP member*

One of the principal attractions of the CCP clearing is the capacity of the device to minimise market disruption on the insolvency of a market participant. For instance, evidence given to the House of Lords European Union Committee described how, on the administration of Lehman Brothers, the clearing house LCH.Clearnet was able to 'liquidate the portfolio and settle outstanding obligations to counterparties … [allowing] Lehman Brothers to default without significant adverse effects on its counterparties'.[132]

But how, as a matter of law, does a CCP provide this effect? The House of Lords in the *British Eagle* case made clear that the CCP's capacity to handle the insolvency of a member turns on the process of novation; it also showed what happens to multilateral clearing arrangements on the insolvency of a member in the absence of a CCP.

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128 Ibid., at p. 185.
129 [1975] 2 All ER 390.
130 *British Eagle International Airlines Ltd* [1975], at 404 (Lord Cross).
131 Wood, *supra* n. 117, at p. 186.
132 HL EU Committee Report, *supra* n. 57, at p. 29.

In *British Eagle*, contractual provisions effected multilateral netting of rights and obligations between member airlines. However, when one member went into liquidation, the contractual provisions for multilateral netting were held to be ineffective in the face of the contrary provisions of the insolvency rules, which required bilateral netting.[133] As Lord Cross explained in the leading speech on behalf of the majority, '[s]uch a "contracting out" must, to my mind, be contrary to public policy'.[134] Thus, in the absence of novation to a CCP, the liquidators of the bankrupt airline were left able to pursue the debtors of the airline for sums owing to it, while its creditors had separately to prove their claims.

In the more recent High Court of Australia case of *Ansett*,[135] the majority found the amended version of the IATA clearing scheme to be effective, notwithstanding the administration of a participant. Significantly, the drafting of the new scheme did not in fact effect novation. However, IATA submitted, and the majority agreed, that:

> under the Clearing House arrangements no liability to effect payment arises between airlines and that the only debt or credit which arises is that between IATA and the member airline in relation to the final, single balance of all items entered for the relevant clearance. This is the consequence of the bargain struck by airlines such as Ansett when they became parties to the relevant multilateral agreements. That construction of the Clearing House arrangements should be accepted.[136]

This case has important implications for the drafting of clearing house rules, though it is submitted that it does not disrupt the central point that novation to a CCP remains the safest and most conventional way of achieving the shock absorber effect on a member's insolvency. It is also worth noting that *Ansett* has attracted academic criticism for being 'generous to the architects of the scheme and somewhat unconvincing in its conclusions'.[137]

In practice then, novation to the CCP means that upon settlement each member of the clearing system owes a net sum of money to or is owed a net sum by the CCP. The members will have to post collateral accordingly. On the default of a member, other members' obligations to pay and be paid stand. The collateral taken by the CCP can be used to meet the CCP's losses because of the default, though, as ISDA explained in evidence to the House of Lords Committee, in the first instance the CCP may look to other clearing members to assume the contracts which the defaulting

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133 At the time, Companies Act 1948, s 302.

134 *British Eagle International Airlines Ltd* [1975], at 411 (Lord Cross).

135 *International Air Transport Association* v. *Ansett Australia Holdings Ltd* [2008] HCA 3.

136 *International Air Transport Association* [2008] HCA 3 [60] and [94] (Gummow, Hayne, Heydon, Crennan and Kiefel JJ).

137 M. Bridge, 'Clearing Houses and Insolvency', 2 *Law and Financial Markets Review* (September 2008) p. 418, at p. 420.

member had on its books.[138] Thus, through a combination of novation, netting and collateralisation CCP clearing protects the markets from disruption on the default of a participant.

However, as Benjamin points out, 'financial law cannot reduce risk, but only moves it from person to person'.[139] In the context of CCPs, this reminds us that while members are protected from direct exposure to counterparty insolvency risk, this risk is assumed by the CCP itself. Therefore, as the Turner Review made clear, the CCP prescription depends (like all CCP clearing) on 'robust and resilient central clearing house arrangements for CDS clearing'.[140] This explains why it is so important that any rules about which contracts are to be cleared do not undermine risk management by clearing houses (as noted above). It also explains why the debate about the regulation and supervision of CCPs, already an important ongoing issue at an international level, has become intertwined with that surrounding the CCP prescription.[141]

3.2.5 *Members' contractual relations*

The final private law component of CCP clearing discussed here is the contractual relationship between the clearing house and the users of its services. This is sometimes overlooked in discussions of CCP clearing and has not received much attention in the debate about the CCP prescription so far. However, it is important in practice since the CCP prescription has the potential to introduce another layer of complexity into the markets.

Parties contracting with a CCP in the manner described must be members of the clearing house. The relationship between the CCP and its members is governed by a membership agreement.[142] Crucially, in light of the CCP's assumption of the insolvency risk of participants, there are criteria which parties have to meet before they are accepted as members of the clearing system. Yates notes that in LCH's case, these relate to matters including 'net capital, appropriate staff and systems'.[143] Yates observes that parties may either be individual clearing members (able to clear their own trades only) or general clearing members (able to clear their own trades and also those of customers who are not members themselves).[144] However, members contract

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[138] Supplementary memorandum by the International Swaps and Derivatives Association (ISDA), HL EU Committee Report, *supra* n. 57, p. 34, at p. 36.

[139] Benjamin, *supra* n. 13, at p. 266.

[140] Turner Review, *supra* n. 10, at p. 82.

[141] As the FSA and HM Treasury note in their recent joint publication about CCPs in the OTC derivatives markets, extending their use 'will further significantly increase the systemic importance of CCPs' thereby heightening the importance of rules imposed on CCPs about their 'capital, risk management, margining and operational standards', FSA and HM Treasury, *supra* n. 43, at p. 14.

[142] Typical obligations therein are discussed in Yates, *supra* n. 93, at p. 320.

[143] Ibid.

[144] Ibid., at p. 318.

with the CCP as principals, even when they are entering into transactions for a client.[145] Needless to say, the law may become quite complex in this area, for example as to whether the non-member is bound by rules and customs of the market (here the clearing service) of which it is ignorant.[146] Yates explains that in the case of LCH, where a member is acting as the agent for a non-member using the clearing services, the member must clear the contract through another general clearing member because otherwise it would be in the position of providing a service to its customer as agent and principal.[147] General clearing members are also required to maintain separate accounts with LCH in respect of house (its own) transactions and client transactions. This separation is extremely important for purposes such as collateralisation.

There has been some concern expressed about how these arrangements will work in the context of the CCP prescription. For example, a recent European Central Bank/Eurosystem report flagged up what it called the 'non-trivial legal issues that will need to be addressed' before arrangements allowing non-dealers trading with clearing members to enjoy the benefits of CCP clearing will become widespread.[148] The FSA and HM Treasury have also expressed concern that legal arrangements allowing non-members access to clearing are sufficiently robust, and regulators are apparently monitoring progress in this respect.[149]

The framers of legislation mandating CCP clearing therefore need to fully consider the problems arising from the capacity of different sorts of market participants to access clearing services. Not all parties which currently enter contracts caught by new legislation will be willing or able to meet the criteria to be clearing members themselves, and the corporate end-users of derivatives hedging business risk again come to mind. Moreover, to the extent that such parties rely on members of the clearing service, there is potential for considerable legal complexity to result from the nature of arrangements which they make. This would be an unwelcome by-product of reform and suggests that it would be sensible either to streamline the means of accessing clearing services for non-financial entities entering relatively low values of deals for the purposes of commercial hedging (perhaps by means of a publicly owned clearing house for non-financial entities only, with lower entry criteria and a maximum limit on participations) or, as the proposed EU Regulation does in some circumstances, to exempt these users entirely from mandatory clearing requirements.

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145 Ibid., and R. Goode, *Commercial Law*, 3rd edn. (London, Penguin 2004), at p. 158.
146 See Goode, ibid., at p. 159, citing, *inter alia*, *Robinson* v. *Mollett* (1875) LR 7 HL 802.
147 Yates, *supra* n. 93, at p. 318.
148 European Central Bank/Eurosystem, *supra* n. 7, at p. 52.
149 FSA and HM Treasury, *supra* n. 43, at p. 13.

3.3 **Private law and the capacity of CCPs**

To sum up, this analysis shows how the legal techniques underpinning CCP clearing help to define the capacity of this device. As shown, CCP clearing means that settlement volumes are reduced, netting facilitated, counterparty risk removed and the markets are insulated should a participant fail. However, the underlying legal techniques mean that there are limitations built into CCP clearing too. Most importantly perhaps, because of how novation works, risk will concentrate in the CCP itself, its own robustness thereby becoming an issue of systemic importance. As a private entity, the clearing house's own management of risk remains crucial, including judging for itself which types of product can be cleared safely. Furthermore, a private law analysis also shows how complexity, legal risk and cost can arise as by-products of contractual relations between members, non-members and the CCP, of the increased use of standardised products and of all-important (as Lehman Brothers showed) asset-backing requirements.

4. IMPLICATIONS FOR THE DEBATE ABOUT THE CCP PRESCRIPTION

As I have argued, CCP clearing may usefully be understood as a private sector legal device, though this aspect of CCP clearing has not been addressed in a coherent way in the debates about the CCP prescription so far. It follows that taking stock of how CCP clearing works with reference to the private law underlying the device offers a means with which to reconsider the complex debate surrounding the CCP prescription, including that following on from framework legislation such as the Dodd-Frank Act. More specifically, this approach assists by isolating two different types of challenges presented by the process of debating and implementing this reform.

In the first place, the analysis above has highlighted certain drawbacks associated with CCP clearing, such as the build-up of risk in the CCP itself. Because these risks, limits and other potential problems originate in the legal workings of the device, they are an inherent and unavoidable part of CCP clearing. Thus, policymakers intent on incorporating CCP clearing into the regulatory response to the financial crisis need to recognise and confront this category of problems as part of the process of designing new legislation.

However, these drawbacks need to be distinguished from a second and distinct type of challenge which relates to the technical implementation of the reform rather than to the inherent legal capacity of the underlying device. There are several difficult and pressing challenges of this nature facing policymakers, a good example of which is the global coordination of reform. As has been recognised by many of the parties involved, it is going to be essential to coordinate new rules mandating CCP clearing across different jurisdictions (e.g., as to the defined terms framing the clearing requirement in each case), as the OTC derivatives markets are sophisticated, global and adept at seeking opportunities for regulatory arbitrage. However,

policymakers implementing the CCP prescription not only have to coordinate their rules; they must also take account of the enormously complex conflict of laws dimension to these reforms. Private international law relating to choice of law and jurisdiction, the holding of cross-border financial collateral, netting, insolvency and financial collateral is relevant here. The litigation generated by the administration of Lehman Brothers (which, it is estimated, may last a decade) is an ongoing reminder of the complexities which arise due to the global nature of the financial markets generally and of the complexities of cross-border interests in financial collateral in particular.[150] Taking account of the private international law dimension of new rules mandating clearing accordingly represents a huge challenge for those seeking to implement the CCP prescription.

The thesis of this paper is that the challenges relating to regulatory arbitrage and conflict of laws are complex and pressing but of a different quality to those arising from the capacity of CCP clearing *per se*. Similarly, decisions about where CCPs should be located[151] or the regulatory methods that are most appropriate for the potentially diverse class of non-clearable contracts turn on issues which are different from those flowing from the mechanics of CCP clearing itself. This distinction is significant because the former are challenges which, in an ideal world, could be pre-empted by regulatory coordination and the careful drafting of new rules, whereas the latter are not. The differences between these two types of problem may therefore be summarised as in Table 1 below.

As this analysis makes clear, both these sets of challenges need to be addressed in the process of implementing the CCP prescription. Both have come up in the global debates in one form or another, but there are advantages in differentiating between them. Not least, this approach allows the debate to be ordered in a more systematic way, which is preferable to policymakers attempting to address qualitatively different issues all together and across multiple forums simultaneously.

How this framework may apply in practice varies depending on the stage of the debates, and it also has potential as a means with which to critique eventual draft, primary or secondary legislation on this issue. One suggestion is that the framework could be used to organise the process of producing draft legislation as follows: as the

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[150] See, for example, the conflicting decisions reached by the Court of Appeal in *Perpetual Trustee Company Limited* v. *BNY Corporate Trustee Services Limited and ors* [2009] EWCA Civ 1160 and by Judge Peck of the US Bankruptcy Court for the Southern District of New York in Ch 11 Case No. 08-13555. Adv. No. 09-01242 (25 January 2010), anticipated in *Perpetual Trustee Company Limited* v. *BNY Corporate Trustee Services Limited* [2009] EWHC 2953 (Ch) and discussed further in C. Brown and T. Cleary, 'Impact of the Global Financial Crisis on OTC Derivatives in Structured Debt Transactions', 5 *Capital Markets Law Journal* (2010) p. 218. The conflict of laws complexities arising in connection with global securities holdings and the use of financial collateral were pointed out presciently in Benjamin and Yates, *supra* n. 120, at chapter 5.

[151] There are currently divergent views about the location of CCPs. For example, the Turner Review argues that the European Commission's proposal that there needs to be a CCP in the euro zone is 'unnecessary for financial stability reasons', Turner Review, *supra* n. 10, at pp. 82-83.

challenges relating to technical implementation need to be pre-empted and most obviously require international cooperation, these should be regarded as 'first order' issues for national and international authorities (including IOSCO and CPSS) to address in a coordinated way and as a priority. Given that the CCP prescription will only be effective if these issues are addressed, authorities should regard these matters as pre-conditions to a separate round of discussion addressing the inherent challenges relating to the legal capacity of CCP clearing, which could be held in closer consultation with the CCP industry and users of clearing services themselves. Thus, the different qualities of the challenges relating to legal and technical implementation issues would be recognised and policymakers would be afforded the opportunity to address each effectively rather than in an ad hoc way.

Table 1: Differentiating challenges relating to the CCP prescription

	Challenges relating to legal capacity	Challenges relating to technical implementation
Examples	• Risk concentrated in CCPs themselves. • Clearing eligibility: requires liquidity, standardisation, clearing house discretion. • Complexity, risk and cost of legal arrangements, e.g., collateralisation, membership.	• Risk of regulatory arbitrage. • Impact of private international law. • Where will CCPs be located? • How to regulate non-clearable products: higher capital charges?
Source	Underlying legal techniques which define the benefits and limits of CCP clearing.	Process of implementing new rules for cross-border markets, particularly on a multi-jurisdictional basis.
Strategy	Challenges are inevitable and need to be recognised and addressed upfront.	Challenges need to be pre-empted by the careful drafting of new rules, by recognition of the limited capacity of CCP clearing and by international coordination.

5. CONCLUDING THOUGHTS

This is a significant moment in the history of financial regulation. As MacNeil and O'Brien put it, the public sector's rescue of the banking system means that the 'power and influence of government within the regulatory matrix has been augmented considerably'.[152] As shown in this paper, the OTC derivatives sector has become a target for duly empowered national and international authorities and the CCP prescription for the OTC derivatives market has accumulated a good deal of

[152] I. MacNeil and J. O'Brien, 'Introduction', in MacNeil and O'Brien, eds., *supra* n. 85, at p. 1.

momentum behind it. However, implementing these proposals has sparked a complex and transnational debate which has not yet yielded finalised legislation (outside the US) or precise rules about how the mechanism will work in practice (even in the US). The argument that I have made in this paper is that within these debates greater recognition should be paid to the fact that CCP clearing is first and foremost a private sector legal device, constructed from private law techniques to serve the market.

From this starting point, I have argued that the debate about implementing the CCP prescription by means of new legislation would be advanced if the private law techniques underpinning it were acknowledged clearly and in detail. Amongst other benefits, this helps to isolate limitations built into CCP clearing from challenges relating to the technical implementation of the reform. Systematising the questions of detail thrown up by this reform would, I have argued, be a constructive step towards effective primary and secondary legislation.

It is in many ways disappointing that a proposal like the CCP prescription should start off with so much high-profile support but nonetheless become so bogged down in technical detail. Importing a regulatory solution from the private sector has likely proved more controversial than advocates expected – there are still vitally important questions about the reform which are unresolved, after two years of discussions. But a private law analysis at least helps to make sense of it all by showing where the complexity comes from the legal mechanics of CCP clearing and where it does not.